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No. 87-1377

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

CHURCH OF SCIENTOLOGY OF CALIFORNIA,

Petitioner,

—against—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

REPLY BRIEF OF PETITIONER

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REPLY BRIEF OF PETITIONER

Introduction

Petitioner Church of Scientology of California ("the Church") submits this reply to correct the significant misleading inferences, omissions, and misstatements of fact and law made in Respondent's Brief in Opposition, by which respondent Commissioner of Internal Revenue ("Commissioner") seeks to evade the important constitutional questions presented by the petition. The Commissioner attempts to obscure the fact that the court of appeals made two critical errors of constitutional law in its disposition of this case. First, it held that a church's payment of royalties to a religion's founder for the sale of the church's scriptures may be held evidence of inurement merely because the religious literature from whose sale those royalties are derived is vigorously promoted. Second, it held that the mere access to and control over church assets by a church's highest officials may be deemed inurement even in the absence of any evidence of personal use of those assets. These holdings, which directly impinge on the Establishment and Free Exercise rights of the Church and threaten the rights of all other religious organizations, warrant review and reversal by this Court.

The Commissioner misportrays the petition in this case as centrally seeking to obtain this Court's reversal of factfinding by the courts below. See Brief in Opposition at 9, citing *Berenyi* v. *Immigration Director,* 385 U.S. 630, 635-36 (1967), and the practice in certain types of cases of declining to review the concurrent findings of two lower courts.[1] While petitioner does contend the court of ap-

[1] Even were this case to turn on reversal of factfindings, the *Berenyi* practice is simply inapplicable in a case such as this raising constitutional issues, as the *Berenyi* Court itself recognized: "To be sure, this Court has not hesitated to undertake independent examination of factual issues when constitutional claims may depend on their resolution [citations omitted]." 385 U.S. at 636. The Court has repeatedly reaffirmed the principle that it has "an obligation to 'make an independent examination of the whole record'

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peals was clearly in error on at least two factual issues, those errors are not critical to the case in its present posture, and the propriety of granting *certiorari* does not turn on consideration of them.[2] The *Berenyi* rule is simply irrelevant to the two critical legal questions presented.

Statement of the Case

1. The Commissioner's statement of the case obscures the fact that, aside from the issue of royalties, the court of appeals found no evidence of overt inurement. While the government recites the salaries paid to Church founder L. Ron Hubbard and his wife, Brief in Opposition at 3, it neglects to mention the court of appeals' holding that, "[w]e cannot say that these salaries were excessive." (App. A15). Although it recites that the Church paid the Hubbards living expenses at the Church's headquarters on the ship *Apollo*, it neglects to include in its statement of

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in order to make sure that 'the judgment does not constitute a forbidden intrusion on the field of [First Amendment rights]' [citations omitted]." *Bose Corp.* v. *Consumers Union of United States*, 466 U.S. 485, 499 (1984).

[2] These errors, discussed *infra*, include: (1) The court of appeals suggested, *contrary* to the Tax Court, that the Church paid Mr. Hubbard royalties on two books authored by two Scientologists but copyrighted to Mr. Hubbard, pursuant to Church policy. In fact, no royalties were paid on these books. In any event, the court of appeals did not rely on its suggestion that royalties actually were paid, but only upon the fact of copyrighting (App. A16), which is not disputed; (2) The court of appeals found that "debt repayments" were made to Mr. Hubbard in 1972 in the amount of $19,324.41. While the Church argues that this finding is clearly erroneous and is wholly contradicted by the record, it is irrelevant to determination of the issues raised in this petition. First, it does not relate to tax years 1970 and 1971, which represent separate causes of action and must be treated separately. *Commissioner* v. *Sunnen*, 333 U.S. 591, 598 (1948). Second, even as to tax year 1972, the court of appeals and tax court holdings rested upon the "cumulative effect" of the various strands of inurement: royalties, copyrighting, "unfettered control," and debt repayments. Reversal on constitutional grounds on any of the first three strands requires a new trial or at least a remand on any remaining strands.

the holding below that the court of appeals made no finding that payment of these expenses was other than reasonable. (App. A15-16).[3]

2. The Commissioner's references to the royalties paid to Mr. Hubbard are misleading by what they omit. The Commissioner neglects to report that the percentages and amount of royalties paid were never held excessive in and of themselves and, in fact, the royalties payments were accepted by the IRS as reasonable and necessary expenses of the Church. *See* Petition at 4, and record references therein. The reason the court of appeals held that the royalties constituted inurement was because of the "aggressive" manner in which the Church proselytized and sold its scriptures, thereby generating royalties. The Commissioner also ignores the fact that there was no evidence that any royalties were paid in 1970. *Id.*

By his silence on the issue, the Commissioner also must be understood to admit what the Tax Court recognized, that no royalties were paid to Mr. Hubbard on publications copyrighted to Mr. Hubbard but written by others. *See* Petition at 5, 17-18.

3. Regarding "debt repayments," the Commissioner ignores the fact that there was no evidence of such payments being made during 1970 or 1971. He also ignores the evidence that the $19,324.41 collected as debt repayment be-

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[3] The Church here notes the Commissioner's prejudicial description of the ship *Apollo* as "a yacht that cruised the Mediterranean Sea," Brief in Opposition at 3, thereby giving the false impression that the Hubbards were on a luxury cruise. During the years in question, the *Apollo* served as the headquarters for the Church's Flag division, its highest ecclesiastic authority (App. B8), and Mr. Hubbard, as the Church's spiritual leader, was actively engaged on the ship in his religious research, developing religious rites and materials and assisting senior Flag staff members in the operation of Flag. *See* Petition at 6 and record citations therein. Mrs. Hubbard was engaged as a high Church official. *Id.* Rather than being luxurious, the ship was nearly forty years old (Ex. 16-P), and its facilities were inadequate for the work of the 300 Scientologists on board, all for religious purposes. *See, e.g.*, RT 1815, 8832.

tween October 9 and December 28, 1972, was never paid to Mr. Hubbard. *See* Petition at 7 & n.3 and 27-28 & n.13.

4. The Commissioner's discussion of funds in the OTC and Trust accounts which were brought on board the *Apollo* is also significant for what it omits. Unacknowledged by the Commissioner is the complete absence of any evidence that the Hubbards turned any of these funds to their personal use. While pointing out that the funds brought on board were kept "in a locked file cabinet to which Mrs. Hubbard had the only keys," Brief in Opposition 3, 4, the Commissioner fails to add that Mrs. Hubbard, as Controller of the Church, had official responsibility for the safekeeping and security of Church funds. *See, e.g.*, Ex. DU pp. 182, Ex. 187 pp. 24, 50. These funds were therefore quite properly under her control.

ARGUMENT

I.

Under The Statute And The Constitution, Payment Of Otherwise Reasonable Royalties Cannot Be Held Evidence Of Inurement Merely Because The Religious Literature On Which The Royalties Are Paid Is Aggressively Promoted.

The Commissioner's characterization of this case as involving "excessive royalties," *see* Brief in Opposition at 8, 9, is fundamentally misleading. This is not a case where the royalty percentages or total amounts paid were held excessive or unreasonable. To the contrary, in its statutory notice, the IRS accepted the royalty payments as reasonable ordinary and necessary business expenses of the Church. *See* record citations, Petition at 4.

The court of appeals found the payments "excessive" on two grounds, both of which present clear legal questions of constitutional right. The first ground on which the finding stands is that the Church aggressively marketed religious works of Mr. Hubbard from which he received royalties. The court of appeals' finding is inex-

plicable in light of its acknowledgment that churches must "rely on distribution of church literature to propagate their faith" and that "a church may pay the author reasonable compensation in the form of royalties for his literary works." (App. A16). More importantly, the finding is clearly unconstitutional in light of the longstanding pronouncements of the United States Supreme Court that the aggressive distribution and sale of religious literature is protected activity under the First Amendment. *See Murdock* v. *Pennsylvania*, 319 U.S. 105, 108-11 (1943), and other authority cited at 12-13 of the Petition. There is absolutely no factual dispute regarding this issue; it is a pure question of constitutional law warranting a grant of *certiorari*.

The second ground on which the court of appeals found "excessive" royalties was that, in conformity with religious doctrine, works by others were copyrighted to Mr. Hubbard, the Church's founder. The Church has demonstrated that a finding of inurement based on this religious practice is an impermissible interference with the Church's internal practices and policies, in violation of the Free Exercise and Establishment Clauses. Petition at 17-18. This is a purely legal question. As the Commissioner's silence in his Brief in Opposition acknowledges, there is no evidence that Mr. Hubbard received royalties on works written by others. And while the court of appeals' statement of facts mistakenly suggests that Mr. Hubbard did receive royalties on books written by others (App. A9),[4] its conclusion of law assumes only that the works were copyrighted to Mr. Hubbard (App. A16). Thus on this second royalty issue, as on the first, a pure issue of constitutional law is presented and the *Berenyi* rule is irrelevant.

The Commissioner's legal discussion fails to address squarely these fundamental constitutional points, and for the most part, addresses points irrelevant here. This case

[4] The Tax Court did *not* make such a finding, and the court of appeals' suggestion, on which it did not rely, therefore does *not* represent fact-finding by two lower courts.

has nothing to do with "excessive salaries" or "commingling" of personal and institutional assets. Brief in Opposition at 7. The cases cited by the government which deal with these questions and with the diversion of organizational assets and earnings for private use are therefore inapposite. See Brief in Opposition at 7-8. *Kenner* v. *Commissioner*, 318 F.2d 632, 634 (7th Cir. 1963) (Physician-founder of "non-profit" hospital commingled personal and hospital funds and diverted hospital income to pay personal liquor and gasoline bills, farm expenses and the like); *Birmingham Business College, Inc.* v. *Commissioner*, 276 F.2d 476 (5th Cir. 1960) (the three shareholders commingled funds and took portions of net earnings of school); *Parker* v. *Commissioner*, 365 F.2d 792, 799 (8th Cir. 1966), *cert. denied*, 385 U.S. 1026 (1967) (founder commingled personal and organizational funds; made unaccounted for withdrawals from organization's accounts; had checks payable to him drawn on organization's accounts); *Founding Church of Scientology* v. *United States*, 412 F.2d 1197, 1201 (Ct.Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) (record contained evidence of loans, reimbursements of unexplained expenditures, and salary payments in absence of evidence of services rendered). *Harding Hospital, Inc.* v. *United States*, 505 F.2d 1068 (6th Cir. 1974), is also inapposite. There, the record showed the hospital was not engaged in substantial charitable work and that interested individuals rented office space at the hospital at far less than fair market value.

The Commissioner also misstates the standard for assessing transactions between charitable institutions and interested individuals, when he implies that property transfers not "at arm's-length" are evidence of inurement. Brief in Opposition at 7. Contrary to the Commissioner's suggestion, the test is not whether a transaction is at arm's length, but whether services comparable to those provided by the interested individual could be obtained from an outside source at a more reasonable cost. *Church by Mail, Inc.* v. *Commissioner*, 765 F.2d 1387, 1392-93 (9th Cir.

1985). Thus, the reasonableness of the cost, not the relationship of the parties is the key factor. *E.g., Harding Hospital, Inc.* v. *United States,* 505 F.2d at 1078 (leasing office space to doctors at fair rental values does not *per se* detract from charitable status of hospital, but inurement found where insider physicians rented office space at rate below fair market value).

Application of the proper standard to this case demonstrates that the royalties paid cannot be evidence of inurement. The percentages and total amounts paid were accepted by the IRS as reasonable. Furthermore, it cannot be contended that the services received—the right to publish religious writings of Scientology's founder—could have been obtained elsewhere at any cost, much less at a cost less than that actually paid to Mr. Hubbard.

The Commissioner fails to understand that it cannot avoid the unconstitutionality of the court of appeals' inurement ruling on royalties merely by characterizing the Church's royalty arrangement as "self-dealing." Brief in Opposition at 9. Since every church has the right to pay reasonable royalties[5] and also has the right to aggressively promote and sell its religious literature, the Commissioner cannot choose to penalize the conjunctive exercise of these rights merely by labeling them as "self-dealing." Rather, the Commissioner is obligated to respect the constitutional protection which covers these activities. Revoking tax exempt status because a church exercises these rights burdens the free exercise of religion and fosters excessive administrative entanglement and interference with church practices in violation of the Establishment Clause. *See* Petition at 14-16.

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[5] A church may also pay reasonable salary and living expenses to its leader, even if he controls the church and thus engages in "self-dealing." This was recognized by both courts below.

II.

Mere Unfettered Control Of Church Assets By Church Leaders Cannot Support A Finding Of Inurement Under The Statute Or The Constitution.

The court of appeals' finding as to covert inurement similarly presents an issue of constitutional law, not requiring review of the court's factual findings. At least as to 1970 and 1971, the record in this case squarely presents the constitutional question whether mere unfettered control of church assets by a church leader can support a finding of inurement.

The Commissioner's arguments as to covert inurement are all premised on misstatements of the record. He suggests that Mr. Hubbard "received an indeterminate share of petitioner's gross receipts" in the form of "debt repayments." Brief in Opposition at 8. There is, however, no evidence of such payments in 1970 or 1971. The court of appeals found that $19,324.41 in debt repayments was collected in October to December 1972 (App. A18), and that these payments made during a four-month period late in 1972 were sufficient to support exemption for all three years (App. A19). This conclusion is incorrect as a matter of law. Each tax year is a separate cause of action and involves different liability. *Commissioner* v. *Sunnen*, 333 U.S. 591, 598 (1048). Thus no factual issues need be addressed to reach the legal conclusion that the finding of covert inurement through debt repayments for 1970 and 1971 must be reversed or remanded for new trial. The Commissioner's cases involving unearned transfer of organizational funds to insiders are therefore inapposite as to those years. *Kenner* v. *Commissioner*, 318 F.2d 632; *Birmingham Business College* v. *Commissioner*, 276 F.2d 476; *Parker* v. *Commissioner*, 365 F.2d 792; *Founding Church of Scientology* v. *United States*, 412 F.2d 1197.[6] *Certiorari* should be

[6] The Church does challenge the court of appeals' factfinding that debt repayments were made to Mr. Hubbard in 1972. It has

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granted as to tax years 1970 and 1971 even if it is denied as to 1972.

In his Brief in Opposition, the Commissioner glosses over the facts that the Church funds transferred from OTC and Trust accounts to the *Apollo* were all accounted for; that the funds were placed in the sole custody of the Church official responsible for safeguarding Church funds; and that there was no evidence or findings whatsoever that these funds were ever turned to the Hubbards' personal use. Thus the "inquiry into whether the founder of [the] religion or another insider has appropriated its profits for his personal use," Brief in Opposition at 10, has been answered in the negative in this case. The Commissioner's contention that there is no Establishment Clause violation in this case is premised on the mistaken assumption that this question could be answered in the affirmative, and is therefore incorrect.

Given the absence of evidence of personal use, the sole remaining thread by which the court of appeals' ruling hangs is that mere access to and control over church assets is evidence of inurement. The argument rests on the proposition that the potential for abuse is a sufficient substitute for real evidence. Neither the consistent IRS and court rulings under the statute nor the Constitution permit this construction. *See* Petition at 19-26.

Under the statute, control of church assets by a church leader must be combined with evidence of specific acts demonstrating private benefit to support a finding of inurement. *See, e.g., St. Germain Foundation* v. *Commissioner*,

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shown that the $19,324.41 collected from October to December 1972 was not paid to Mr. Hubbard. Petition at 7-8 & n. 3 and 27-28 & n. 13. As demontrated above, this factual dispute has no bearing on the disposition of tax years 1970 and 1971. It is, however, also unnecessary for the Court to reach this factual issue even to remand for a new trial as to 1972. Because the court of appeals' based its inurement holding on the "cumulative effect" of the findings of overt inurement (royalties) and convert inurement (App. A 20), reversal of the royalty finding alone would require a remand as to 1972.

26 T.C. 648, 660 (1956). Since numerous other churches place church assets in the unfettered control of church leaders without losing tax exempt status, the revocation of the Church's exemption on this basis would create a denominational preference in violation of the Establishment Clause. The Commissioner entirely fails to address this constitutional violation.

The Commissioner in his brief also makes no attempt to address or defend the contention of the court of appeals that mere unfettered control warranted revocation because "here the Church transferred millions of dollars to bank accounts controlled by a private individual who had no official responsibility for managing church assets." (App. A17). Tax distinctions made on the basis of which official a church chooses to entrust with its funds also create denominational preferences and excessive entanglement in the form of surveillance of and intrusion into religious decisionmaking. *See* Petition at 24-25. The Commissioner is again silent with respect to these constitutional violations.

CONCLUSION

For the reasons stated, the petition for a writ of *certiorari* should be granted.

Respectfully submitted,

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